GREENWOODS
+ HERBERT
SMITH
FREEHILLS

Mr David Hawkins
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600
CIVreform@treasury.gov.au

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Dear Mr Hawkins

Exposure Draft - Treasury Laws Amendment *(Corporate Collective Investment Vehicle) Bill 2017* (December 2017)

Thank you for the opportunity to make this submission on the Treasury Laws Amendment *(Corporate Collective Investment Vehicle)* Bill 2017 ('**the ED**') and accompanying Exposure Draft Explanatory Materials ('**the EM**') released in December 2017.

This submission focusses on the tax dimensions of the project to create a pass-through Collective Investment Vehicle in corporate form; where relevant, we have referred to some aspects of the regulatory regime released as Treasury Laws Amendment *(Corporate Collective Investment Vehicle)* Bill 2017 in August 2017.

1 General observations

Most of this submission addresses particular issues and questions we have from examining the text of the ED but we do wish to record some general comments about disappointing policy choices made in designing the regime.

The impetus for the ACCIV regime was the 2009 report Australia as a Financial Centre - Building on our Strengths issued by the Australian Financial Centre Forum (the Johnson Report) which argued, 'the lack of widespread use or recognition of unit trusts in the region contributes to Australian based funds management companies typically using collective investment vehicles that are established and administered offshore ...' and consequently recommended a flow-through tax regime for certain kinds of companies. Clearly, the government hopes that this regime will be more familiar to a foreign audience and, by virtue of the comparable tax regime, both foreign investors and local fund managers will now be largely indifferent between using a trust and company.

Having regard to the matters noted below, it is unlikely that an ACCIV will be attractive to fund managers outside niche situations. The potential downsides from conducting investment activities through an ACCIV will almost always mean that it is an inferior vehicle to an AMIT. If the objective of this project is to create a vehicle that will be attractive only to non-resident retail investors investing in debt and listed equities, then this criticism has less impact. But if the objective is to create a vehicle that will have broad appeal to local and international investors across asset classes, the ACCIV is quite deliberately made unattractive.

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1.1 Under and overs

Our first policy concern relates to item 433 in the ED. Apparently, Treasury has decided to take the opportunity presented by this project to re-write the agreed policy settings that underpin a critical part of the AMIT rules: the 'unders-and-overs' regime in Div 276-F.

The provisions in Div 276-F and Div 284 TAA 1953 were the result of protracted negotiations between Treasury, the Australian Taxation Office, the profession and the private sector during the long gestation of the attribution regime. It was recognised that the AMIT rules had to codify and regularise the pragmatic solution of allowing AMITs to rectify errors in the year of discovery rather than to require re-issue of taxation statements and creation of investor amended assessments. Such a regime benefits trustees, investors and the ATO alike, and had been a key recommendation in ch 8 of the Board of Taxation's 2009 report, *Review of the Tax Arrangements Applying to Managed Investment Trusts - A Report to the Assistant Treasurer.*

There were careful and extended deliberations over the next decade about an appropriate way to ensure the unders-and-overs mechanism did not pose a threat to the integrity of the tax system. The April 2015 ED proposed that the amount of an under would be increased if the under was material, but that model was acknowledged to be impractical.

The uplift model was abandoned in favour of an administrative penalty, imposed on the trustee, and triggered only if the under or an over arose from the intentional or reckless disregard of the law. This outcome reflected an acknowledgment that trustees are under an obligation to act in the best interests of their members and so manipulation of the tax system through unders or overs would expose trustees to personal legal liability. This outcome satisfied all parties – including the Australian Taxation Office - the unders-and-overs regime was workable (i.e., trustees did not have to re-do their attributions in order to avoid an administrative penalty provided they could demonstrate the mistake was not deliberate) and integrity concerns were addressed.

Unfortunately, item 433 changes that bargain. Reducing the culpability threshold from intentional disregard to lack of reasonable care will expose trustees to penalty more often (and may mean the unders-and-overs regime will be treated by trustees as effectively unavailable). It is unfortunate but unavoidable that trust distribution calculations and processes have to be finalised within a few weeks (typically, in August in each year); investors insist on it and it is a requirement that AMMA / AIVMA statements be issued before the end of September. It is inevitable that not all information is available to the trustee of an AMIT within that time frame (consider counts flowing through tiers of trusts) and so estimates have to be made. But more importantly, the opportunity for second- and third-round checking for data entry errors, computer programming and manual calculations simply does not exist. The position of AMITs and ACCIVs is thus different to any other taxpayer entity.

In these circumstances it is inappropriate to penalise trustees for errors that are not deliberate or reckless. The former threshold was set at the right level of culpability at the time it was agreed, and it remains the right threshold for imposing penalties.

Various entities have made irrevocable elections to be AMITs based on the enacted scope of the unders-and-overs regime. While taxpayers must accept that tax laws are subject to change, the unders-and-overs regime was one of two or three fundamental features of the AMIT regime and its abandonment cannot be treated as akin to the adjustment in the value of a penalty unit. If item 433 is to be retained, AMITs must be given the option to revoke their election into the regime.

The treatment of overs under item 433 is even more difficult to follow. Unlike any other taxpayer, it is seemingly proposed that an AMIT / ACCIV be penalised for carelessly overstating its income. That is, if a AMIT / ACCIV makes a conservative estimate of depreciation because it has insufficient time to undertake a detailed review of its calculations and thereby overstates its taxable income, it may be liable for a penalty in respect of the additional tax that its investors pay.

The existing penalties for AMIT overs can be justified on the basis that they relate to circumstances where there is manipulation of the income tax positon of an AMIT. However, this justification cannot possibly extend to 'careless overs'.

If the regime proposal is enacted, it must be assumed that trustees of AMITs and ACCIVs will re-issue statements instead of using the unders and overs regime. Re-issuing statements means that there will be no under or over to be penalised and the ATO will be left to pursue thousands of investors for small amounts of tax and interest. This outcome would benefit neither industry nor the revenue.

1.2 Double taxation

According to the EM [para 1.120] where a company fails for some reason to meet the ACCIV requirements in a year, it becomes a taxpayer again and so will have to pay corporate tax on its taxable income for that year. However, the company does not re-enter the imputation system and so distributions that it pays to investors (including on-distribution of franked dividends the company received) will be unfranked, even though a company has already paid tax on that income. On the other hand, a trust which fails to meet the AMIT requirements in a year will usually retain its flow through status (unless it is a public trust that has engaged in trading activities). Even where the trust does lose its flow through status (and is effectively taxed as a company), the trust enters the imputation system so that distributions can be franked.

This difference is a deliberate policy choice to create a penalty – it is 'intended to be a disincentive for funds registering as a CCIV, without ever having the intention of electing into the ACCIV tax regime' but it will affect both ACCIVs which encounter an unexpected problem as well companies which were spurious from the start. We understand that no benefit from deliberate failure to qualify as an ACCIV has been identified, but the double taxation regime has been introduced 'just in case.' We doubt this is a plausible scenario, and, if it is, we are confident it could be easily handled in other ways.

In our submission there is no basis for creating this penalty just for companies and it should be removed. If an ACCIV fails to meet the tests in any year it should revert back to being a company, both for itself and for its investors.

If the Government is committed to double taxation as a policy setting, it must accept that there will be few ACCIVs. The fact that failure to qualify as an AMIT or ACCIV may be rare in practice will not alter this outcome. A rational fund manager will not choose a vehicle that has a potentially penalty when another vehicle is available that is otherwise the same but does not carry that penalty.

1.3 Penalties under the CGT regime

The same argument applies to the other deliberate penalty in these rules – the denial of CGT discount where an ACCIV makes a capital gain that would be a discount gain if made by an AMIT. Div 276-JA will extend CGT-only treatment to many of the assets of an ACCIV but that deeming apparently does not extend to its logical conclusion – that the amount being computed by the AIV is also a discount capital gain [see EM paras 1.93 and 1.94]

> 1.93 Consistent with the operation of the CGT discount capital gains rules that apply to companies, ACCIVs are not entitled to discount capital gains that they make when working out their taxable income.

There are several consequences which arise from insisting on having different CGT treatment for ACCIVs and they all make an ACCIV unattractive.

Since no amendment is being made to s. 115-10, an ACCIV will not able to make a discount capital gain itself. Presumably this means that an ACCIV will not have a 'component' which is a discount capital gain arising from a CGT event with its own assets that can be attributed to its investors. This means the relevant computations for an AMIT and an ACCIV will be quite different. For example,

	AMIT	*ACCIV*
Gross gain	100	100
- CGT discount	(50)	---
- expenses	(40)	(40)
Amount to be attributed and taxed in investor's hands	10	60
Reduction to investor's cost base if 60 distributed [event M1]	(50)	nil

But the analysis is apparently different if the CGT event happens to an asset of a trust in which the ACCIV holds units. The trustee of a trust is included under s. 115-10 in the types of entities that can make a capital gain. Para 1.94 of the EM implies this distinction between capital gains on assets held by the ACCIV itself and capital gains which flow into the ACCIV because it is a unitholder, and says that Div 276 will allow that component to flow through the ACCIV unaffected:

> 1.94 However, if an ACCIV receives an amount that meets the conditions to qualify for a discount capital gain, the amount will retain that tax character as it flows through the ACCIV to its members.

Presumably this means the calculation would work as follows:

	AMIT	*ACCIV*
Trust		
Gross gain	100	100
- CGT discount	(50)	(50)
- expenses	(30)	(30)
Share of net income to which AMIT / ACCIV is presently entitled	20	20
AMIT / ACCIV		
Amount included in ACCIV's assessable income (s. 115-210)	40	40
- CGT discount	(20)	
- expenses	(10)	(10)
Share of net income to which investor is presently entitled	10	30
Reduction to AMIT's/ACCIV's cost base in units if 70 distributed [event E4]	0	(30)

Individual Investor

Amount attributed and taxed		
in investor's hands	20	30
- CGT discount	(10)	(15)
Assessable income	10	15
Reduction to investor's cost base in ACCIV		
shares if 60 distributed [Event M1]	(50)	(45)

Presumably, this means the ACCIV will only 'own' its portfolio of assets by holding interests in trusts which hold and realise the assets. This seems an entirely unnecessary complication.

Finally, one suspects it means an ACCIV will be reluctant to make the CGT election in Div 276-JA. The upside to making the election (access to CGT discount for investors) is not available but the downside of CGT treatment (quarantining of losses) would be triggered. While not making the election will expose the ACCIV to mandatory revenue treatment under s. 276-720 for most non-land assets, it is not obvious that this will weigh heavily in the consideration.

The proposed treatment will create another point of difference between AMITs and ACCIVs. In our submission there is no basis for creating this penalty just for collective investment vehicles that are companies and it should be removed.

2 Particular comments

2.1 Key elements of the overall design

(a) Switching off reality

The starting point for the AIV rules is that a CCIV will be a company in form. This means, if the tax treatment of an ACCIV and its investors is to be equated with the tax treatment of an AMIT and its investors, it is necessary first to switch off the rules that would otherwise impose tax on ACCIVs and their investors (but leave these rules in place for a CCIV that is not an ACCIV).

Remove tax on the ACCIV on its taxable income.

Item 432 in the ED amends s. 23(2)(a) of the Income Tax Rates Act. It seems to us that this provision should be (i) dis-applying the corporate rate from all ACCIVs, regardless of the size of the ACCIV, but (ii) should be leaving the corporate rate in place so that it applies to CCIVs that are not ACCIVs.

While there is currently a degree of uncertainty about the future of the Rates Act in light of possible amendments under *Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017* and the more contentious *Treasury Laws Amendment (Enterprise Tax Plan No 2) Bill (2017)*, it seems to us even if both of these Bills passed in their current form, an amendment to s. 23(2)(a) (whether in its current form or as amended) would still leave corporate tax applying to a non 'base rate entity' – that is a ACCIV that is either too large or which exceeds the 80% passive income test [ie, all of them].

Secondly, the amendment in item 432 would mean that no corporate tax would apply to a CCIV (as well as an ACCIV) and since that kind of CCIV is not an AIV, its investors are not being taxed on an attribution basis.

We believe neither outcome would be intended and so we submit that some clearer drafting is needed to (i) remove corporate tax from all ACCIVs but (ii) not from companies which are CCIVs but not ACCIVs.

<u>Remove tax (both tax by assessment and tax by withholding) from dividends distributed to shareholders in an ACCIV.</u>

Item 436 in the ED amends the definition of 'dividend' so that distributions made by ACCIVs will not be assessable in the hands of shareholders under s. 44 except to the extent that they represent distributions received by the ACCIV. This appears to work properly for s. 44 but will not remove possible assessability of a corporate distribution (including a dividend) under s. 6-5 – the lesson of the McNeil decision is that s. 6-5 always remains a further point for taxation and so needs to be switched off as well. That happens in other contexts; for example, the demerger rules have been drafted on the basis that it is necessary to switch off both s. 44 [s. 44(3)] and s. 6-5 [s. 44(4)] where a demerger is effected by way of a dividend. It might be Treasury's view that s. 104-625 is sufficient to achieve this outcome but it is surrounded by so many qualifications that there must be some risk it will not be satisfied in individual cases. A straightforward rule that distributions from an ACCIV are always NANE could achieve this outcome much more clearly.

Moreover, with respect to investors, item 436 only addresses distributions from companies that are dividends in fact; it says nothing about the very many rules which deem amounts to be dividends in the hands of shareholders (sometimes, though not always, as a result of the exercise of discretion by the Commissioner). For example, it seems shareholders in ACCIVs would still face exposure to rules such as s. 47, Div 16K, or s. 45B. No similar exposure exists for investors in AMITs. One suspects the ATO would insist that s. 104-625 is not sufficient to remove the application of these rules – it is conflict between 2 specific provisions neither of which seems to have any obvious claim to superiority and exclusivity.

Secondly, with regard to dividend withholding tax, item 425 switches off all withholding tax for income derived by a person who is 'a member of a CCIV throughout that year of income.' Item 426 ensures that an amount to which DWT or IWT would otherwise apply, nevertheless remains NANE under s. 128D.

The requirement that the non-resident must be a member throughout the income year seems odd. It would mean that the liability to withholding tax under Div 11A ITAA 1936 depends on how long the foreigner held their investment in the CCIV. We note that liability to withholding tax under Div 840-M does not contain a similar requirement. We can't help wondering if this drafting wasn't actually trying to impose a requirement that the company be a CCIV throughout the entire income year (in the same way that Div 840-M insists that the entity must be a withholding AIV for the entire year).

Secondly, we would have expected that DWT and IWT (and not MITWT) would apply to the portion of a fund payment made by an ACCIV to a non-resident that represents a dividend or interest received by the ACCIV. In order for this to work properly,

- the new definition of dividend for s. 6 would need to flow through into the definition in s. 128A for DWT purposes (which appears to be what happens),
- a rule similar to the s. 6 rule would be needed so that interest received by an ACCIV remains as interest rather than a dividend paid by the ACCIV for WT purposes – this does not appear to happen (i.e., there does not appear to be an amendment to s.128B that actually imposes tax on ACCIV DIR payments).

We would also have expected that DWT would continue to apply to dividends paid by a CCIV that was not also an ACCIV.

Again we submit that some clearer drafting is needed to (i) remove DWT from all ACCIV dividends except to the extent that the distribution represents dividends received by the ACCIV, (ii) attach IWT instead of DWT to the part of a distribution that represents interest received by the ACCIV, and (iii) not remove DWT (nor attach IWT) to distributions paid by companies which are CCIVs but not ACCIVs and (iv) not make those rules turn on whether the investor held their shares for a month or a year.

<u>Not compute taxable income of the CCIV under the rules for companies.</u>

If the alignment of AMITs and ACCIVs were to be made complete there are many other changes that would need to be made to switch off other rules that currently apply to companies and will continue to apply to an ACCIV. For example, the ACCIV will be subject to the corporate loss-duplication rules in Subdivision 165-CD despite not having the option to form a consolidated group like other companies. The ED does not attempt a comprehensive re-creation of the flow-through paradigm for ACCIVs.

(b) Switching on the alternative rules

The second step in equating the tax treatment of an ACCIV and its investors to that of an AMIT and its investors is to attract the rules that apply to AMITs. Most of the ED is directed to this task but the drafting is complex because of the differing approaches taken in the ED –

- **consolidation**: sometimes the ED both attracts the AMIT paradigm to an ACCIV and then combines the existing AMIT rules and the new ACCIV rules; a new single AIV regime is created; and
- **duplication**: at other times, the ED just creates a set of rules for ACCIVs which mirrors those for AMITs; two systems run in parallel.

And creating the legislative parallel is made more complicated because of the 3 non-contiguous variants of MITs:

- **MITs** [Div 275]: the calculation of their net income is affected by deemed CGT treatment [Div 275-B] and the special regime for taxing non-arm's length income [Div 275-L]; their investors and / or the trustee are assessed pursuant to Div 6; a unitholder's cost base is calculated under CGT event E4
- **withholding MITs**: non-residents investors in the MIT are liable to the tax imposed under Div 840-M in lieu of tax under Div 6; that tax is collected under the procedures in Div 12-H and Div 12A Tax Administration Act; resident investors and / or the trustee are assessed pursuant to Div 6; a unitholder's cost base is calculated under CGT event E4
- **AMITs**: the calculation of their net income is affected by deemed CGT treatment [Div 276-JA] and the special regime for taxing non-arm's length income [Div 276-GA]; the calculation of its net income is affected by deemed fixed trust treatment [Div 276-B] and the unders-and-overs system [Div 276-F]; its non-resident investors may be taxed by assessment under the attribution regime in Div 276 [s. 276-105] or under the MITWT rules in Div 840-M / Div 12-H and Div 12A; its resident investors and the trustee are assessed exclusively under the attribution mechanism in Div 276; a unitholder's cost base is calculated under CGT event E10 (to become CGT event M1) not event E4.

The ED creates at least three new types of entities, but maybe more:

- **CCIVs**: the calculation of their taxable income is not affected by deemed CGT treatment or the special regime for taxing non-arm's length income; they are apparently not taxpayers (but see above); their resident investors are assessed pursuant to s. 44; their non-resident investors are not liable to withholding tax or tax by assessment (but see above); a shareholder's cost base is calculated under CGT event G1
- **ACCIVs**: the calculation of their taxable income is affected by deemed CGT treatment [Div 276-JA] and the special regime for taxing non-arm's length income [Div 276-GA]; they are not taxpayers; their resident investors are assessed pursuant to Div 276; their non-resident investors are liable to withholding tax under Div 840-M and Div 12-H and 12A of the Tax Administration Act; a shareholder's cost base is calculated under CGT event M1
- **Withholding ACCIVs**: the ED uses the terms 'withholding AIV,' 'withholding MIT' and 'withholding ACCIV'. It seems that only an '*A*CCIV' can be a 'withholding *A*CCIV' [s. 12-384] and only a withholding ACCIV can be a withholding AIV [s. 12A-207]. So there appears to be a difference from the

treatment of MITs: only an ACCIV can be an AIV but a MIT that is not an AMIT can still be an AIV. This presumably means that a withholding ACCIV attracts all the tax consequences of an ACCIV.

The second step in achieving parity with AMITs would be to attract to shareholders in ACCIVs treatment that is currently available only to unitholders in AMITs. For example, the 'qualified person' rules in former Div 1A of Part IIIAA ITAA 1936 generally adopt a look-through approach for shares held through trusts, but they also attempt to make the 45-day rule work in more straightforward manner for unitholders in a widely-held trusts. In general terms, s. 160APHP applies the 45-day test to the unitholder's interest in the trust where the trust is widely-held. It is not clear whether shareholders in ACCIVs will meet (or fail) the 45-day rule based on the length of time during which they held their interest in the ACCIV or the length of time the ACCIV held the shares in the company paying the dividend. And it is not clear just how the 45-day rule is meant to work when it is considered alongside the mechanics of attribution: the shareholder in the ACCIV has no actual (and no deemed) position in relation to the shares ***held by*** the ACCIV; it does have a position in relation to its shares ***in the ACCIV*** but the shareholder is not being assessed on a dividend in respect of those shares. This disconnect needs an explicit legislative solution.

There are no doubt many problems of this kind that will only become apparent over the course of the next few years (and if past experience with the AMIT rules is indicative, will not be fixed by amending legislation). We encourage Treasury to think more carefully about the second-order consequences of applying the attribution paradigm to a company rather than a trust. At present, the ED seems quite incomplete.

Impose tax on the ACCIV when a trustee would be taxed.

Having switched off tax from ACCIVs, it is then necessary to re-impose tax on the ACCIV (and not through attribution to investors) when a trustee would be taxed instead of unitholders.

This will occur under Div 276-105, Div 276-G and Div 276-GA (for non-arm's length amounts, amounts attributed to non-residents by a non-withholding ACCIV, defects in the attribution process, and so on).

This part of the ED appears to work correctly to assess amounts either to the trustee of an AMIT or to the AIV where it is an ACCIV.

The only query we have is whether more amendments are needed to imposition Acts and the Rates Act in order for those provisions (i) to impose tax in the case of a ACCIV and (ii) to stipulate the rates.

1. The tax currently imposed on the trustee of a (non-withholding) AMIT by s. 276-105(2)(a) is set out in s. 12(6A) and Schedule 10 of the *Income Tax Rates Act 1986*. Those provisions refer to the rate of tax payable by 'a trustee.' The substituted provision will now assess 'the AIV (or if the AIV is an AMIT, the trustee of the AMIT).' We can find no amendments to the Rates Act to provide the rates for the taxes when the ACCIV is being assessed.

2. Similarly, tax is currently imposed on the trustee for defects arising in the attribution processes under ss. 276-405(2), s. 276-410(2), 276-415(2) and 276-420(2). These taxes will now be assessed to ' the AIV (or, if the AIV is an AMIT, the trustee of the AMIT):'

   - In the case of the tax under s. 276-410, it is currently separately imposed by s. 3 the *Income Tax (Attribution Managed Investment Trusts – Offsets) Act 2016*, and the rate is stipulated in s. 4 as 100%. We can find no amendment to the Imposition Act but an amendment is probably unnecessary because the provisions if the Imposition Act seem capable of applying to the expanded s. 276-410.

   - However, for the other provisions, the relevant parts of the Rates Act [ss. 12(11), 12(12) and 12(13)], only refer to the tax 'payable by a

trustee ...' Again, we can find no amendment to the Rates Act to deal with the situation where the tax is payable by the AIV.

3 Finally, the rate of tax payable by the AIV under Div 276-GA where it earns non-arm's length income is, according to the Note to s. 276-439(2), meant to be set out in 's. 12(10A)' of the *Rates Act*. This section does not currently exist and does not appear to be included in the ED.

2.2 No fund payment

The ACCIV regime contains no equivalent to s.275-50, which enables a trust to qualify as an AMIT when no fund payment is made.

Like the test for MITs, many of the tests to be an ACCIV must be satisfied at the time that it makes the first fund payment in respect of an income. However, if a CCIV chooses to retain cash, or all of its distributable income relates to dividends, interest and royalties, then it will not make a fund payment and cannot qualify as an ACCIV. It follows that all of its income would be subject to tax at the corporate rate of tax.

There is no stated policy intention behind this omission and it appears to be an oversight.

2.3 Trading business restriction – proposed s. 276-35

Under current law, a public unit trust will suffer the consequences set out in Div 6C ITAA 1936 for a year of income if it carries on a trading business. It is also excluded for that year from being able to qualify as a MIT [s. 275-10(4)] and as a consequence it cannot be a withholding MIT or an AMIT. It is important to note, however, that the exclusion from being a MIT, a withholding MIT and an AMIT is independently triggered even if Div 6C is not actually triggered for the trust (as well as those cases where it is) [ie, s. 275-10(4)(a) versus s. 275-10(4)(b)].

It seems to be the intention of the drafters that the ED will –

- leave the definition of 'trading business' in Div 6C unamended. The definition of 'trading business' will be met if the trust conducts a business that does not consist entirely of eligible investment business, as defined. Section 102MC offers some protection to 'a trustee of a unit trust' from being treated as carrying on a trading business if the trustee earns a small amount of some other types of income. (Additional safeguards in s. 102MB operate through the definitions of investing in land and rent and so amend the basic definitions of trading business and eligible investment business);
- leave s. 275-10(4) unamended so that the trading business prohibition for MITs is set out there, using the definitions in Div 6C. The definition of 'trading business' in s. 102M ITAA 1936 (including the effects of s. 102MB) is thus incorporated into Div 275 and whatever protection is afforded by s. 102MC would flow through to the trustee of a MIT; and
- enact a similar prohibition for ACCIVs (but not MITs) in s. 276-35, using the definition of 'trading business' in s. 102M ITAA 1936 [ie, s. 276-20(1)(c) - which is the definition of ***ACCIV*** - incorporates s. 276-35, but s. 275-10(4) - which is the definition of ***MIT*** - does not]. The definition of 'trading business' in s. 102M ITAA 1936 (including the effects of s. 102MB) is thus incorporated into Div 276. But since s. 102MC only applies to the 'trustee of a unit trust', it is not automatically enlivened for Div 276 and so s. 276-35(2) mirrors the terms of s. 102MC for an ACCIV.

Assuming this is the design, this appears to work correctly – the protection in s. 102MB flows through automatically and the protection in s. 102MC is consciously replicated for ACCIVs.

With regard to articulating the 2% test (which is not 'safe harbour'), the provisions of s. 276-35(2)(b) seem unduly harsh since:

- it applies the 2% test on a per sub-fund basis; and

- failure of the 2% test causes failure to be an ACCIV, rather than merely the loss of application of a safe harbour.

In our submission, the consequences of engaging in trading activities should be visited on sub-funds. In the absence of such an approach, fund managers may decide they need to limit potential damage to their investors by having multiple ACCIVs (each with one active and one dormant sub-fund). This is inefficient.

Casting the 2% test as a prohibition also makes ACCIVs less attractive that AMITs in that an AMIT can potentially rely on the 25% safe harbour in s.102MB even if it does not satisfy s.102MC. An ACCIV that fails the 2% safe harbour does not have this option. In our submission, the appropriate course of action is simply to amend s.102MC to apply to entities, such that the treatment of MITs and ACCIVs is the same.

2.4 Div 124-N rollover

Items 251-261 in the ED amend Div 124-N to allow an AMIT convert into an ACCIV without triggering CGT in the hands of the trustee or unitholders at that time. The existence of these provisions suggests Treasury expects (and wants to encourage) AMITs to convert into ACCIV form.

But if the rollover is to be attractive it needs to be more comprehensive than Div 124-N currently allows:

- Div 124-N does not afford protection for the trustee against triggering income tax on the transfer of assets to the ACCIV – s. 124-875(1) only protects against triggering a 'capital gain.' Protection is also needed against triggering income tax, including for example balancing adjustment amounts on depreciating assets and TOFA financial arrangements;
- Div 124-N does not recognise that losses may exist trapped within the trust (which is about to be wound up). These quarantined losses should be available to the successor entity;

It would also be helpful if Treasury could approach the State and Territory governments to facilitate discussions about stamp duty reorganisation rollover relief where the AMIT's assets include land or land-rich duty might be triggered.

2.5 Treaty issues

Our next comment relates to the ability of ACCIVs to access the benefits of Australia's tax treaties with respect to their foreign source income and investments.

One of the key drivers of this measure was the concern expressed in the 2009 report *Australia as a Financial Centre - Building on our Strengths* issued by the Australian Financial Centre Forum (the Johnson Report) about 'complexity and uncertainty with respect to the extent to which funds structured as unit trusts can benefit under some of Australia's double tax treaties' [p. 62].

We are concerned that, by choosing to achieve transparency through the mechanism of removing ACCIVs from the compass of the Income Tax Rates Act 1986, they may not be entitled to treaty benefits. We note that ACCIVs are still liable to income tax under the Income Tax Act 1986 though we are not sure that other countries will be persuaded that the difference between (i) a company that is not liable to income tax and (ii) one that is taxable but with no rate stipulated is a distinction that has consequences for them. (In fact the situation is more complicated than this because the ACCIV will be (or at least is meant to be – see above) a taxpayer in certain situations where the ACCIV is taxed in lieu of a non-resident beneficiary [s. 276-105] and because of some defect in the attribution process [Div 276-G]. In neither of these cases, however, is the ACCIV being taxed because it is the owner of the relevant income.)

While this may mean that benefits should instead be claimed directly by the investors in the ACCIV, this is clearly impractical in widely-held investment vehicles. The impracticality explains why we recently have invested so much effort in adding to our important treaties measures to extend treaty benefits directly to transparent

intermediaries such as Australian MITs. (And just to be clear, the provisions in our treaties (eg, art 3(1)(m) of the NZ treaty and art 10(4)(d) of the US treaty) which deliver treaty benefits directly to a MIT investing offshore are drafted so that they only benefit a 'managed investment trust' and will not include ACCIVs.)

Benefits under Australia's tax treaties will be available to an entity which is a 'resident' of Australia as defined in art 4 of the treaty. Most of our treaties will define a resident by reference to Australian domestic law. For example, the UK treaty says an entity is a resident of Australia if it is 'a resident of Australia for the purposes of Australian tax.' This may be sufficient to allow an ACCIV to claim benefits.

But the terms of some of Australia's treaties will soon be modified by the commencement of the Multilateral Instrument. Article 3 of that treaty will provide,

> Article 3 - Transparent Entities
>
> 1. For the purposes of a Covered Tax Agreement, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting Jurisdiction shall be considered to be income of a resident of a Contracting Jurisdiction but only to the extent that the income is treated, for purposes of taxation by that Contracting Jurisdiction, as the income of a resident of that Contracting Jurisdiction.

While Australia has nominated a reservation with respect to Article 3 for some of our treaties, there must be a real prospect that some of our treaty partners will not regard ACCIVs as entitled to treaty benefits.

This problem needs to be addressed, either by some change to our view on Article 3 or by adopting some other method of achieving transparency (such as a dividend paid deduction system) which will not create this problem.

2.6 Anti-hybrid measures

A similar problem may arise from the anti-hybrid measures currently being adopted in some countries. Again, the problem arises from choosing to achieve transparency through the mechanism of removing ACCIVs from the compass of the *Income Tax Rates Act 1986*.

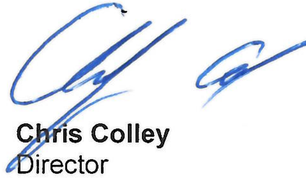
It is quite possible that other countries will come to view Australia's ACCIVs are tax exempt entities leading to D/NI and DD outcomes. This means anti-hybrid measures can be triggered for payments made to an ACCIV, in effect denying the payer a deduction for the interest or other payment it is making. That means non-residents could be reluctant to accept capital from Australian ACCIVs with adverse consequences for the ACCIV and its investors –

For example, an ACCIV may have to invest in bonds issued by Company A which pay 4% even though bonds issued by Company B would pay 5%. If Company B cannot deduct the interest expense because Company B is seen in its country as making a payment to a 'reverse hybrid' it may simply not be willing to deal with an ACCIV. In the language of our proposed Div 832, so far as Australia (the ***formation country***) is concerned, the ACCIV is not a liable entity and another entity (the non-resident investors) are; but in the ***investor country*** the ACCIV is probably seen as a company and a liable entity and the investors are not (unless there is actual and timely distribution). Because the payer in ***Country B*** can't be sure whether the ACCIV will actually distribute to investors (or just attribute and retain) it may simply prefer to have nothing to do with Australian ACCIVs.

This problem needs to be addressed, but options for resolving it by any unilateral action on Australia's part are limited. The obvious and straightforward solution is to scrap the attribution notion in favour of a dividend-paid deduction model but this runs counter to the logic of having a regime specifically intended to allow attribution without distribution. Another option might be to make the ACCIV liable to tax under the Income Tax Rates Act but give it a notional deduction for foreign income received. This is not an easy problem

and any solution will require much more thought and possibly co-operation by other countries.

Yours sincerely



Manuel Makas
Director
Greenwoods & Herbert Smith Freehills

+61 2 9225 5957
+61 421 050 630
manuel.makas@greenwoods.com.au

Chris Colley
Director
Greenwoods & Herbert Smith Freehills

+61 2 9225 5918
+61 427 069 821
chris.colley@greenwoods.com.au